INTERNAL REVENUE SERVICE

IRS News Release

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Health Insurers Get More Time from IRS To Make Incentive Payments

IR-2004-90, July 6, 2004

WASHINGTON — The IRS has issued guidance today to health insurance companies and health maintenance organizations (HMOs) giving them more than 2 ½ months from the end of their tax year to make incentive payments and still take the related deduction.

Health insurance companies and HMOs have developed arrangements with physicians, groups of physicians and other health care providers where, after the end of the insurer's taxable year, they make incentive payments to the health care providers for meeting objectives related to providing quality health care in a cost-efficient manner.

Normally, the company could not take a deduction for the payments for the year for which the incentive payment applies if they were made more than 2 ½ months after the end of the taxable year. These companies face unique administrative challenges in performing the relevant calculations, and often need more than 2 ½ months to collect the necessary data and complete those calculations. Under the guidance issued today, these companies will not be held to the 2 ½ month period.

"We believe that this guidance eliminates any controversy over treatment of incentive payments to physicians and other health care providers and relieves health insurers and HMOs of an administrative burden that is unnecessary, in light of the special rules that apply to insurance companies under the tax law," said Deborah Nolan, Commissioner of the Large and Midsize Division of the Internal Revenue Service. "This guidance was a direct result of IRS employees working with representatives of the health insurance industry to solve tax problems through the Industry Issue Resolution program."

The Industry Issue Resolution (IIR) program was launched in 2001 by the IRS and tackles tax issues submitted by taxpayers, associations and other groups representing businesses. The objective is to resolve frequently disputed or burdensome tax issues more efficiently.

The guidance, Revenue Procedure 2004-41, attached, will appear in Internal Revenue Bulletin 2004-30, dated July 26, 2004. Information on the IIR program is found in Revenue Procedure 2003-36 and is available at IRS.gov.

- Revenue Procedure 2004-41, (PDF 25K)
- Revenue Procedure 2003-36, (PDF 82K)

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Part III

Administrative, Procedural, and Miscellaneous

26 CFR 601.204: Changes in accounting periods and in methods of accounting.
(Also: Part I, §§ 404, 832, 846; 1.404(b)-1T, 1.404(d)-1T, 1.832-4)

Rev. Proc. 2004-41

SECTION 1. PURPOSE

This revenue procedure sets forth circumstances under which an insurance company that makes incentive payments to health care providers will be permitted to include those payments in discounted unpaid losses without regard to § 404 of the Internal Revenue Code. The revenue procedure also provides procedures under which a taxpayer may obtain automatic consent of the Commissioner to change its method of accounting for such payments.

SECTION 2. BACKGROUND

.01 Section 404(a) provides that if compensation is paid or accrued on account of any employee under a plan deferring the receipt of compensation, the compensation is not deductible under chapter 1 of subtitle A (§§ 1 through 1400L), but if the compensation would otherwise be deductible, it is deductible under § 404, subject to the limitations imposed by § 404 as to the amounts deductible in any year.

.02 Section 404(a)(5) provides the general rule that compensation paid under a nonqualified plan (contributions to which are not deductible under §§ 404(a)(1), (2), or (3)) of deferred compensation is deductible in the taxable year in which an amount attributable to the contribution is includible in the gross income of employees participating in the plan.

.03 Section 404(b) provides that if there is no plan, but there is a method or arrangement that has the effect of a plan deferring the receipt of compensation, § 404(a) shall apply as if there were a plan.

.04 Section 404(d) extends the application of § 404(a) to benefits or compensation paid to nonemployees by providing that if a plan would be covered by § 404(a) (as modified by § 404(b)) but for the fact that no employer-employee relationship exists, the contributions or compensation (if otherwise deductible under chapter 1 of subtitle A) shall be deductible for the taxable year in which an amount attributable to the compensation is includible in the gross income of the persons participating in the plan.

.05 Section 1.404(b)-1T, Q&A-1, of the temporary Income Tax Regulations provides, in part, that section 404(a) and (d) govern the deduction of compensation paid or incurred with respect to plans, or methods or arrangements, however denominated, that defer the receipt of any amount of compensation or benefit, including fees and other payments. Under §§ 404(a) and (b), if otherwise deductible, a contribution paid or incurred with respect to a nonqualified plan, or method or arrangement, is deductible in the taxable year of the employer in which or with which ends the taxable year of the employee in which the amount attributable to the contribution is includible in the gross income of the employee (without regard to any applicable exclusions under chapter 1, Subtitle A).

.06 Section 1.404(d)-1T provides, in part, that in the case of deferred benefits or compensation for service providers with respect to which there is no employer-employee relationship, §§ 404(a) and (b) and the regulations thereunder apply as if the person providing the services were the employee and the person to whom the services are provided were the employer.

.07 Section 1.404(b)-1T, Q&A-2(a), provides that a plan, or method or arrangement, defers the receipt of compensation or benefits to the extent an employee receives compensation or benefits thereunder more than a brief period of time after the end of the employer's taxable year in which the services creating the right to such compensation or benefits are performed. The determination whether a plan, or method or arrangement, defers the receipt of compensation or benefits is made separately with respect to each employee and each amount of compensation or benefit.

.08 Section 1.404(b)-1T, Q&A-2(b)(1), provides that a plan, or method or arrangement, is presumed to be one that defers the receipt of compensation for more than a brief period of time after the end of an employer's taxable year to the extent that compensation is received after the 15^{th} day of the third month after the end of the employer's taxable year in which the services are rendered (the 2-1/2 month period).

.09 Under § 1.404(b)-1T, Q&A-2(b)(2), the taxpayer may rebut this presumption only by demonstrating that it was impracticable to avoid the deferral of the receipt by an employee of the amount of compensation or benefits beyond the applicable 2-1/2 month period and that, as of the end of the employer's taxable year, such impracticability was unforeseeable.

.10 Section 832(a) defines the taxable income of an insurance company subject to tax under § 831 as the gross income defined in § 832(b)(1), less the deductions authorized by § 832(c).

.11 Section 832(b)(1) provides that the gross income of an insurance company subject to tax under § 831 includes the combined gross amount earned during the taxable year from investment income and from underwriting income, computed on the basis of the underwriting and investment exhibit of the annual statement approved by the National Association of Insurance Commissioners.

.12 Section 832(b)(3) defines underwriting income as the premiums earned on insurance contracts during the taxable year, less losses incurred and expenses incurred.

.13 Section 832(c)(4) authorizes a deduction for "losses incurred" on insurance contracts during the taxable year, as defined in § 832(b)(5).

.14 Section 832(b)(5) defines losses incurred during the taxable year on insurance contracts as follows: (1) from losses paid during the taxable year, deduct salvage and reinsurance recovered; (2) to the results so obtained, add all unpaid losses on life insurance contracts plus all discounted unpaid losses (as defined in § 846) outstanding at the end of the taxable year and deduct all unpaid losses on life insurance contracts plus all discounted unpaid losses outstanding at the end of the preceding taxable year; (3) to the results so obtained, add estimated salvage and reinsurance recoverable as of the end of the preceding taxable year and deduct estimated salvage and reinsurance recoverable as of the end of the taxable year.

.15 Section 1.832-4(b) provides, in part, that the part of the deduction for losses incurred that represents unpaid losses must comprise only actual unpaid losses. These losses must be stated in amounts that, based on the facts of each case and the company's experience with similar cases, represent a fair and reasonable estimate of the amount the company will be required to pay. Amounts included in, or added to, the estimates of unpaid losses that, in the opinion of the director, are in excess of a fair and reasonable estimate will be disallowed as a deduction. The director may require any insurance company to submit such detailed information with respect to its actual experience as is deemed necessary to establish the reasonableness of the deduction for "losses incurred."

.16 Section 846 provides that the amount of discounted unpaid losses as of the end of the taxable year attributable to any accident year is equal to the present value of the losses, determined by using the amount of undiscounted unpaid losses at such time, the applicable interest rate, and the applicable loss payment pattern. Section 846(b)(1) provides, in general, that the term "undiscounted unpaid losses" means the unpaid losses shown in the annual statement filed by the taxpayer for the year ending with or within the taxable year of the taxpayer. For purposes of determining discounted unpaid losses attributable to accident and health insurance contracts (other than certain disability insurance contracts), § 846(f)(6)(B) provides that the unpaid losses are considered to be paid in the middle of the taxable year following the accident year.

.17 Under § 446(e) and § 1.446-1(e)(2)(i), a taxpayer generally must secure the consent of the Commissioner before changing a method of accounting for federal income tax purposes. Section 1.446-1(e)(3)(ii) authorizes the Commissioner to prescribe administrative procedures setting forth the terms and conditions necessary to obtain consent to change a method of accounting. Rev. Proc. 2002-9, 2002-1 C.B. 327 (as modified and clarified by Announcement 2002-17, 2002-1 C.B. 561, modified and amplified by Rev. Proc. 2002-19, 2002-1 C.B. 696, and amplified, clarified, and modified by Rev. Proc. 2002-54, 2002-2 C.B. 432), provides procedures by which a taxpayer may obtain automatic consent to change to a method of accounting described in the Appendix of Rev. Proc. 2002-9.

.18 Many taxpayers that are taxable under Part II of subchapter L of Chapter 1, including both health insurance companies and health maintenance organizations (HMOs), have developed arrangements with physicians and other health care providers that encourage participating providers to provide quality health care to subscribers in a cost-efficient manner. Under one such arrangement, a portion of the provider's fees is held back and paid after the end of the insurer's taxable year if certain objectives are met. Under another such arrangement, the provider is entitled to a bonus payment if specified objectives are met. The objectives set by the insurer often relate to cost savings, profitability, number of claims, quality of care, or preventive medicine. The terms of these incentive programs are not negotiated between the taxpayers and the health care providers and the taxpayers do not offer providers the alternative of not participating in these arrangements.

.19 The incentive payments described in Section 2.18 often are based on data for a performance period that can only be collected after the end of the taxpayer's taxable year. As a result, the payments often are made to providers more than 2 1/2 months after the end of the taxpayer's taxable year.

.20 For purposes of the annual statements filed with their state insurance commissioners, health insurers and HMOs treat the amount of incentive payments made to health care providers during the year as part of claims paid. The taxpayers also are required to include estimates of the liability for incentive payments incurred during the year as part of their total incurred but not paid claims reserves. The taxpayers usually determine the liability for incentive payments on the basis of an actuarial calculation, taking into account the relevant contractual arrangements with health care providers, the contractually defined experience outcomes by which the incentive payments will become payable to the health care providers, and an analysis of the taxpayers' aggregate health care costs through the valuation date.

.21 Applying § 404 and the regulations thereunder to incentive payments made by the taxpayers would create a substantial administrative burden for the taxpayers and the Service**,** since the liabilities for incentive payments shown on the annual statements filed by health insurance companies and HMOs generally are not broken down into amounts that will be owed to specific health care providers. In light of existing rules and limitations placed on the deductibility of loss reserves under subchapter L, and in order to reduce controversy regarding the treatment of these incentive payments, the Service has decided that it will not apply § 404 to provider incentive payments described in section 4 of this revenue procedure.

SECTION 3. SCOPE

This revenue procedure applies to taxpayers using or changing to the method of accounting for provider incentive payments set forth in section 5 of this revenue procedure.

SECTION 4. PROVIDER INCENTIVE PAYMENTS

A payment by a taxpayer to a health care provider is a “provider incentive payment” within the meaning of this revenue procedure if—

.01 the taxpayer is taxable as an insurance company under Part II of subchapter L;

.02 the payment is made pursuant to a written arrangement the purpose of which is to encourage participating health care providers to provide quality health care to the taxpayer’s subscribers in a cost-efficient manner;

.03 the taxpayer’s liability for the payment is dependent on the attainment of one or more preestablished goals during a performance period consisting of not more than 12 consecutive months;

.04 the terms of the arrangement pursuant to which the payment is made are established unilaterally by the taxpayer, and are not negotiated with the health care providers;

.05 the taxpayer normally makes payments to health care providers under the arrangement within 12 months after the close of the performance period referred to in section 4.03 of this revenue procedure;

.06 deferring the receipt of income by the health care provider or otherwise providing a tax benefit to the provider is not a principal purpose of the arrangement;

.07 the taxpayer records a liability for the payment on its annual statement filed for state regulatory purposes, and includes this liability in the determination of discounted unpaid losses under § 846; and

.08 the health care provider is not an employee, and is not providing health care as an agent, of the taxpayer.

SECTION 5. APPLICATION

A taxpayer that makes provider incentive payments within the meaning of this revenue procedure is permitted to include those payments in discounted unpaid losses without regard to § 404.

SECTION 6. CHANGE IN METHOD OF ACCOUNTING AND AUDIT PROTECTION

.01 *Change in method of accounting.* A change in an insurance company's method of deducting provider incentive payments to the method provided in section 5 of this revenue procedure is a change in method of accounting to which the provisions of §§ 446 and 481 apply. If a taxpayer within the scope of this revenue procedure wants to change its method of deducting the liability for provider incentive payments to the method provided in section 5 of this revenue procedure, the taxpayer must follow the automatic change in method of accounting provisions of Rev. Proc. 2002-9, with the following modifications:

(1) The scope limitations in section 4.02 of Rev. Proc. 2002-9 do not apply to a taxpayer that wants to make the change for either its first or second taxable year ending on or after December 31, 2003.

(2) A taxpayer that wants to make the change for its first taxable year ending on or after December 31, 2003, and that on or before September 24, 2004, files its original federal income tax return for that year, and that did not change to the method described in section 5 of this revenue procedure on that return is not required to comply with the filing requirement in section 6.02(3)(a) of Rev. Proc. 2002-9, provided the taxpayer complies with the following filing requirements. The taxpayer must instead complete and file the Form 3115, Application for Change in Accounting Method, in duplicate. The original Form 3115 must be attached to an amended federal income tax return for the taxpayer's first taxable year ending on or after December 31, 2003. This amended return must be filed no later than January 24, 2005. The copy of the Form 3115 must be filed with the national office (see section 6.02(6) of Rev. Proc. 2002-9 for the address) no later than when the taxpayer's amended return is filed; and

(3) For purposes of Line 1a of Form 3115, the designated number for the automatic accounting method change is “90“.

.02 *Audit protection*. If a taxpayer within the scope of this revenue procedure currently uses a method consistent with the method described in section 5 of this revenue procedure, the method of accounting for the taxpayer’s provider incentive payments will not be raised as an issue by the Service in a taxable year that ends before December 31, 2003. Also, if a taxpayer currently uses a method consistent with the method described in section 5 of this revenue procedure, and its use of that method is an issue under consideration (within the meaning of section 3.09 of Rev. Proc. 2002-9) in examination, before an appeals office, or before the U.S. Tax Court for any taxable year that ends before December 31, 2003, that issue will not be further pursued by the Service.

SECTION 7. EFFECTIVE DATE

This revenue procedure is effective for taxable years ending on or after December 31, 2003.

SECTION 8. EFFECT ON OTHER DOCUMENTS

Rev. Proc. 2002-9 is modified and amplified to include this automatic change in method of accounting in section 4B of the APPENDIX.

SECTION 9. DRAFTING INFORMATION

The principal authors of this revenue procedure are Gary E. Geisler of the Office of Associate Chief Counsel (Financial Institutions & Products) and William C. Schmidt of the Office of Division Counsel/Associate Chief Counsel (Tax Exempt & Government Entities). For further information regarding this revenue procedure contact Mr. Geisler at (202) 622-3970 (not a toll free call) or Mr. Schmidt at (202) 622-6030 (not a toll free call).

Part III

Administrative, Procedural, and Miscellaneous

Industry Issue Resolution Program

Rev. Proc. 2003-36

SECTION 1. PURPOSE

This revenue procedure describes procedures for business taxpayers, industry associations, and other interested parties to submit issues for consideration under the Internal Revenue Service's Industry Issue Resolution (IIR) Program. The objective of the IIR Program is to identify frequently disputed or burdensome tax issues that are common to a significant number of business taxpayers that may be resolved through published or other administrative guidance. Resolving issues through prefiling guidance rather than postfiling examination is a goal of the Internal Revenue Service and the Office of Chief Counsel. The Large and Mid-Size Business Division and the Small Business and Self Employed Division of the Service share operational responsibility for the IIR Program.

SECTION 2. BACKGROUND

In Notice 2000-65, 2000-2 C.B. 599, the Service announced the Industry Issue Resolution Pilot Program. The objective of the pilot program was to establish a procedure to address frequently disputed tax issues that are common to a significant number of large or mid-size business taxpayers through prefiling guidance rather than postfiling examination. After evaluating the success of the pilot program, the Service announced in Notice 2002-20, 2002-17 I.R.B. 796, that the IIR Program would be made permanent. In addition, Notice 2002-20 expanded the IIR Program to address issues common to small businesses, as well as large and mid-size businesses, and to address opportunities to reduce burden for all business taxpayers.

SECTION 3. SCOPE

.01 Issues appropriate for the program.

The issues most appropriate for consideration under the IIR Program generally will have two or more of the following characteristics:

(1) The proper tax treatment of a common factual situation is uncertain.

(2) The uncertainty results in frequent, and often repetitive, examinations of the same issue.

(3) The uncertainty results in taxpayer burden.

(4) The issue is significant and impacts a large number of taxpayers, either within an industry or across industry lines.

(5) The issue requires extensive factual development, and an understanding of industry practices and views concerning the issue would assist the Service in determining the proper tax treatment.

.02 Issues not appropriate for the program.

The following issues are not appropriate for consideration under the IIR Program:

(1) Issues that are unique to one or a small number of taxpayers.

(2) Issues that are primarily under the jurisdiction of Operating Divisions of the Service other than the LMSB and SB/SE Divisions.

(3) Issues that involve transactions that lack a bona fide business purpose, or transactions with a significant purpose of improperly reducing or avoiding federal taxes.

(4) Issues that involve transfer pricing or international tax treaties.

SECTION 4. RECOMMENDATION AND SELECTION PROCESS

.01 Recommendation process.

The LMSB and SB/SE Divisions will review and evaluate the issues submitted under the IIR Program and, if appropriate, may recommend that an issue be included on the Treasury Department's and the Service's Guidance Priority List for the upcoming year or on periodic updates to the Guidance Priority List. The Guidance Priority List sets forth the published guidance that the Service expects to issue during the plan year. Inclusion of an IIR item on the Guidance Priority List does not, however, guarantee that the Service will issue published guidance on the item.

Interested parties may submit issues at any time during the year. The LMSB and SB/SE Divisions will review and evaluate the issues submitted under the IIR Program at least semi-annually, generally after March 31 and August 31 of each year. Additionally, the LMSB and SB/SE Divisions will review issues submitted by May 15, 2003, to determine whether to recommend those issues for inclusion on the 2003-2004 Guidance Priority List.

.02 Selection process.

A recommendation under this revenue procedure does not guarantee that the issue will be selected for inclusion on the Guidance Priority List or included on a periodic update of the Guidance Priority List. In deciding whether to include issues recommended by the LMSB Division or SB/SE Division under this revenue procedure for inclusion on the Guidance Priority List, the Office of Chief Counsel and the Treasury Department will consider, among other things, recommendations from other sources, and whether the requested guidance promotes sound tax administration.

An LMSB or SB/SE representative will notify the submitter when a decision has been made whether to include an issue on the Guidance Priority List or on a periodic update. A public announcement on the issues reviewed under the IIR Program and selected for the Guidance Priority List or a periodic update will be issued at least annually. The announcement will include the name of the officials to contact for information regarding the selected issues.

SECTION 5. GUIDANCE FOR SELECTED ISSUES

Guidance on selected issues may be in the form of published guidance, such as a regulation, revenue ruling, revenue procedure, or notice, prepared by the appropriate Office of the Associate Chief Counsel. In some situations, the guidance may require taxpayers to file a request for a change in method of accounting before changing the manner in which they treat the issue. Published guidance issued under the IIR Program is available on the Digital Daily at www.irs.gov. Selected issues also may be addressed in administrative guidance, such as an Internal Revenue Manual provision.

SECTION 6. ADDITIONAL INFORMATION ABOUT THE IIR PROGRAM

.01 IIR team.

If an issue submitted under the IIR Program is selected as a published guidance project, the Service will establish a team (the IIR team) to provide assistance in analyzing the issue. IIR team members will include appropriate personnel from the LMSB and SB/SE Divisions, Appeals, the Office of Chief Counsel, and the Treasury Department.

.02 Requests for information or meeting.

An IIR team may request that the submitter or other business taxpayers voluntarily meet with the Service, provide information or provide an opportunity for the Service to review books and records to assist in the development of the issue. These activities are not for the purpose of examination or inspection within the meaning of section 7605(b).

.03 Disclosure of information.

The Service encourages interested parties to submit information that will assist the Service and the Treasury Department in reaching an appropriate resolution of the issue. Submissions and any additional information provided may be subject to disclosure under the Freedom of Information Act. All submissions made under the IIR Program will be made available for public inspection and copying in their entirety. Therefore, submissions should not include confidential or taxpayer specific information.

SECTION 7. SUBMITTING ISSUES UNDER THE PROGRAM

.01 No required format.

An issue submitted for consideration under the IIR Program is not required to be submitted in a particular format. The submission should, however, include an issue statement, a description of why the issue is appropriate for the IIR Program, an explanation of the need for guidance, the estimated number of taxpayers affected by the issue, and the name and telephone number of a person to contact if additional information is needed. The submission may also include a recommendation as to how the issue may be resolved.

.02 Where to submit issues.

Interested parties should submit issues by e-mail to IIR@irs.gov.

Alternatively, submissions may be mailed or faxed to:

Internal Revenue Service
Office of Prefiling and Technical Services
Large and Mid-Size Business Division LM:PFT
Mint Building 3rd Floor M3-420
1111 Constitution Avenue NW
Washington, DC 20224
Fax: 202-283-8406

SECTION 8. EFFECT ON OTHER DOCUMENTS

This revenue procedure supersedes Notice 2002-20.

SECTION 9. EFFECTIVE DATE

This revenue procedure is effective April 17, 2003.

SECTION 10. PAPERWORK REDUCTION ACT

The collections of information contained in this revenue procedure have been reviewed and approved by the Office of Management and Budget in accordance with the Paperwork Reduction Act (44 U.S.C. 3507) under control number 1545-1837.

An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless the collection of information displays a valid OMB control number.

The collections of information in this revenue procedure are in Sections 6 and 7. This information is required to submit a request for the Service to consider an issue under the IIR Program. This information will be used to enable the Service to determine whether the issue is suitable for determination under the IIR Program. The collections of information are voluntary to obtain a benefit. The likely respondents are business or other for profit institutions.

The estimated total annual reporting burden is 2,000 hours.

The estimated annual burden per respondent varies from 4 hours to 200 hours, depending on individual circumstances, with an estimated average of 40 hours. The estimated number of respondents is 50.

The estimated annual frequency of responses is on occasion.

Books or records relating to a collection of information must be retained as long as their contents may become material in the administration of any internal revenue law. Generally tax returns and tax return information are confidential, as required by 26 U.S.C. 6103.

SECTION 11. CONTACT INFORMATION

The principal author of this revenue procedure is Donna Welch of the Office of Associate Chief Counsel (Procedure and Administration), Administrative Provisions and Judicial Practice Division. Ms. Welch may be contacted at (202) 622-4910 (not a toll-free number). For information regarding the IIR Program, please contact Susan Blake, Senior Program Analyst, of the LMSB Prefiling and Technical Services Office at (202) 283-8414 (not a toll-free number) between the hours of 9:00 AM – 5:00 PM, Eastern Time, Monday through Friday.